IT 00-8
Tax Type: **Income Tax**
Issue: **Statute of Limitations Application**
Financial Organization(s) (General)
Investment Tax Credit
Unitary – Inclusion of Company(ies) In A Unitary Group
Reasonable Cause on Application of Penalties
80/20 Rule

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	No. 96-IT-0000 FEIN: 00-00000000 Tax yrs.: 3/31/91, 3/31/92, 3/31/93
v.	
"ABC TELECOM CORP.", Taxpayer	Charles E. McClellan Administrative Law Judge

RECOMMENDATION FOR DECISION

Appearances: Rickey A. Walton and Mark Dyckman for the Department of Revenue. Marilyn A. Wethekam, Karen L. Black, and Brian L. Browdy of Horwood, Marcus & Berk for the taxpayer.

Synopsis:

This matter involves three Notices of Deficiency ("NOD") issued by the Department to "ABC Telecom Corp." ("ABCT") for Illinois income tax due for the taxable years ended March 31, 1991, March 31, 1992, and March 31, 1993. After filing its initial protest, "ABC Communications Corp." ("ABCC"), the parent of "ABCT", filed an amended protest to which it attached three refund claims. The refund claims were denied.

A pre-trial order was entered on April 13, 1999, specifying the issues in the following terms:

1. Whether the NOD issued for the tax year ended March 31, 1991, was issued within the prescribed time period set forth in Section 905.[1]

2. Whether the NOD issued for the tax year ended March 31, 1991, is invalid because the notice was not issued to the designated agent consistent with 86 Ill. Adm. Code §100.5220.

3. Whether the NOD issued for the tax years ended March 31, 1992, and March 31, 1993, is invalid because the notice was not issued to the designated agent consistent with the requirements of 86 Ill. Adm. Code §100.5220.

4. Whether "ABC Financial Management Corporation" ("ABC"ABCFMC"") is an investment company and excluded from the unitary group pursuant to IITA § 1501(a)(27).

5. Whether "ABC "ABCEQ" Corporation" ("ABCEQ") is an investment company and excluded from the unitary group pursuant to IITA § 1501(a)(27).

6. Whether "ABC International Telecommunications" ("ABCIT") is an "80/20" corporation and thus, excluded from the unitary group pursuant to IITA § 1501(a)(27).[2]

7. Whether the sales factor of the apportionment formula was correctly computed.

8. Whether the penalty imposed for the years in issue pursuant to IITA § 1005 was erroneously imposed because sufficient funds had been paid to the Department to pay both the amount shown due on the IL-1120 forms as filed plus the proposed deficiencies determined by the Department.

9. Whether the penalty imposed pursuant to IITA § 5/1005 should be abated because the Taxpayer had reasonable cause for the underpayment.

An evidentiary hearing was held on December 7, 1999, and the taxpayer filed a post-hearing brief. I recommend that the NOD dated June 18, 1996, for the years ended

[1] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act ("IITA" or "the Act").

[2] Taxpayer has conceded that "ABCIT" should be included in taxpayer's unitary group for the year ending March 31, 1993. Taxpayer brief. p. 7, fn. 5. Citations to taxpayer's brief will be referred to herein as "Taxpayer br." and page number as "p."

March 31, 1992, and March 31, 1993, identifying the taxpayer by an incorrect FEIN (00-0000000) be canceled. I also recommend that the other NOD dated June 18, 1996, for the taxable year ended March 31, 1991, and the NOD dated October 31, 1997, for the years ended March 31, 1992, and March 31, 1993, be made final, that the taxpayer's claims for refund be denied, and that IITA § 1005 penalties not be abated.

Findings of Fact:

1. "ABCC" is the common parent of an affiliated group of corporations, including "ABCT", the named taxpayer in this matter. Taxpayer Group Ex. No. 3, p. 3, Attachment 6.
2. "ABCC" was named the designated agent for the group as required by 86 Admin Code ch. I, § 100.5220(a). *Id*.
3. The federal employment identification number for "ABCC" is 01-0000000. Taxpayer Group Exhibit No. 4.
4. "ABCC" and its affiliates, including "ABCT", filed combined unitary returns for the years at issue. Taxpayer Group Ex. No. 11, p. 1.[3]
5. "ABC"ABCFMC"" and "ABCEQ" filed separate Illinois income tax returns for the year ended March 31, 1991. Taxpayer Group Ex. No. 1.
6. "ABC"ABCFMC"" and "ABCEQ" did not file Illinois income tax returns for the years ended March 31, 1992, and March 31, 1993. Taxpayer Group Ex. No. 4.
7. If "ABC"ABCFMC"" and "ABCEQ" are determined not to be financial organizations, they are members of "ABCC's" unitary group includible in its combined unitary returns.

[3] Taxpayer Group Ex. No. 11 is a copy of the comments section of the report prepared by the Department's auditor who conducted the Department's audit for the years at issue.

8. The Department issued a NOD to "ABCT" (FEIN 02-0000000) on June 18, 1996, proposing a statutory deficiency for the taxable year ended March 31, 1991, of $760,186, consisting of tax ($585,695), penalty under Section 1005 ($174,491) and interest ($252,975) for a total amount due of $1,013,161. Dept. Ex. No. 1.

9. Two documents are attached to this NOD. The first document is entitled "Computation for Notice of Deficiency". It identifies "ABCT" as the addressee. The second document (two pages) entitled "Unitary Audit Result Input Form-Part II" lists the designated agent for the unitary group as being "ABCC" and lists "ABCC" and its affiliates. *Id.*

10. The Department issued a second NOD to "ABCT" on June 18, 1996, proposing statutory deficiencies for the taxable years ended March 31, 1992, and March 31, 1993. This NOD, which identified "ABCT" by an incorrect FEIN (13-0000000), proposed an assessment of tax for the year ended March 31, 1992, of tax ($402,245) and penalty under Section 1005 ($94,886). For the taxable year ended March 31, 1993, this NOD proposed an assessment of tax ($496,334) and penalty under Section 1005 ($87,799). Interest was also assessed for both years. Dept. Ex. No. 2.

11. Three documents are attached to this NOD. The first document (two pages) is entitled "Computation for Notice of Deficiency". It identifies "ABCC" as the addressee. The second document entitled "Explanation of Adjustments" identifies the taxpayer as being "ABCC" and subsidiaries. The third document (two pages) entitled "Unitary Audit Result Input Form-Part II" lists the designated agent for the unitary group as being "ABCC" and lists "ABCC" and its affiliates. *Id.*

12. The Department issued a revised NOD to "ABCT", which listed "ABCT's" correct FEIN (01-0000000), on October 31, 1997, for the taxable years ended March 31, 1992, and March 31, 1993, proposing the same amount of tax for each year as was proposed in the June 18, 1996, NOD but with the Section 1005 penalties recalculated to $127,947 for the year ended March 31, 1992, and $128,594, for the year ended March 31, 1993. Additional interest was also added. Dept. Ex. No. 3.

13. One document is attached to this NOD (two pages), entitled "Computation for Notice of Deficiency", and it identifies "ABCT" as the addressee. *Id*.

14. The periods established by the statute of limitations for the assessment of tax for each of the years at issue were extended to December 31, 1997, written consent forms signed on behalf of "ABCT" by a corporate vice president. Attached to each is a statement entitled "Attachment to IL-872, Consent to Extend the Time to Assess or Refund Income Tax for years ending 3/31/91 3/31/92. It lists "ABCC" as the company for whom the statutory periods are being extended. Taxpayer Group Ex. No. 1, attachments 2, 3.

15. "ABCC" filed amended income tax returns for each year at issue claiming that "ABCIT" should be excluded from its combined Illinois income tax returns. Taxpayer Group Exhibits No. 3, 4.

16. "ABCC" and various affiliates provide a wide spectrum of voice and data communication services to their customers. Taxpayer Group Ex. No. 1, attachments 2, 3.

17. "ABC"ABCFMC"" and "ABCEQ" are wholly owned subsidiaries of "ABCC" that were incorporated in Delaware. *Id.* at pp. 2, 3. Taxpayer Group Ex. No. 1, p. 5.

18. "ABC"ABCFMC"" makes subordinated loans to subsidiaries of "ABCC". Taxpayer Group Ex. No. 11, p. 2.

19. "Robert W. Downing", "ABCC's" president, signs as the officer of "ABC"ABCFMC"" for the loans. *Id*.

20. The officers of "ABC"ABCFMC"" are also officers of "ABCC". *Id*.

21. The officers of "ABCEQ" are also officers of "ABCC". *Id*. at p. 3.

22. Both "ABC"ABCFMC"" and "ABCEQ" invest surplus cash of "ABCC" and manage portfolios of debt, commercial paper, and equity investments. Taxpayer Group Ex. No. 3, p. 5; Taxpayer Group Ex. No. 4, p. 4; Taxpayer Group Ex. Nos. 7, 8; 9, 10 Tr. pp. 47- 50.

23. Their income is comprised of passive investment type income, such as dividends, interest and capital gains. *Id*.

24. "ABCC's" treasury department maintains the records for the investments of funds for most of "ABCC's" affiliates. Tr. p. 50.

25. "ABCIT" is engaged in the business of transmitting international telecommunications traffic. Taxpayer Group Ex. No. 3, p. 7; Taxpayer Group Ex. No. 4, p. 7.

Conclusions of Law:

Failure to Issue the NOD's to the Designated Agent

"ABCC" argues that the NOD's for all three years at issue are invalid because they were not mailed to the designated agent as required by 86 Admin Code ch. I, § 100.5220(b). Taxpayer br. p. 18. That section of the regulation requires members of an affiliated group to name the common parent corporation as the agent for receiving NOD's.

It also states that NOD's will be mailed only to the designated agent and that such mailing will be considered as being a mailing to each member of the group. "ABCC" correctly maintains that each of the three NOD's involved in this case was addressed to "ABCT" instead of to the designated agent, "ABCC". Dept. Exs. No. 1, 2, 3.

The documents of record establish that the "ABCC" unitary group previously elected to be treated as a single taxpayer as provided by IITA § 5/502. Pursuant to this election, the "ABCC" unitary group, including "ABCT" but excluding "ABC"ABCFMC"" and "ABCEQ", filed combined returns, not separate returns, for years at issue. Therefore, the Department's audit must address the entire unitary group of corporations because any deficiency assessment or refund would affect all companies in the group because of the mechanics of combined apportionment.

However, notwithstanding the fact that the NOD's were addressed to the wrong member of the "ABCC" unitary group, "ABCC" was listed as the designated agent on the attachments to the NOD's. "ABCC" has cited no authority in support of its assertion that this error renders the NOD's invalid. The language of the regulation suggests that the designated agent rule was designed to simplify the notification process for unitary groups of corporations. Neither the regulation nor any statute provides that such notice is a jurisdictional requirement invalidating the NOD if addressed to a member of the unitary group other than the designated agent. "ABCC" and its affiliates clearly had actual notice of the proposed assessments and the opportunity to exercise their statutory administrative rights. "ABCC" does not argue that it was prejudiced in any way and there is nothing in the record to indicate the contrary. Therefore, the fact that the NOD's were addressed to a

member of the unitary group other than the designated agent does not render them invalid or void.

Statute of Limitations Issue

"ABCC" argues that "ABCFMC" and "ABCEQ" cannot be included in "ABCC"'s unitary group for the year ended March 31, 1991, because they filed separate returns, the NOD was issued on June 18, 1996, more than three years after the time period allowed for assessment by IITA § 905, and "ABCFMC" and "ABCEQ" did not agree to extend the statutory assessment period. This argument was raised in "ABCC's" original and amended protests (Taxpayer Group Ex. No. 3 p. 2) but it was not argued either at the evidentiary hearing or in "ABCC's" brief.

"ABCC's" position is incorrect, however. "ABCC" and the members of its unitary group filed combined returns for the years at issue. For the years at issue, the statute regarding unitary groups of corporations provided as follows:

> For taxable years ending on or after December 31, 1985, and before December 31,1993, taxpayers that are corporations (other than Subchapter S corporations) having the same taxable year and that are members of the same unitary business group may elect to be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in the election to file the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act. This subsection (e) does not permit the election to be made for some, but not all, of the purposes enumerated above.
> 35 ILCS 5/502(e).

"ABCC" and its affiliates elected to be treated as a single taxpayer and filed combined Illinois income tax returns. "ABCT" signed successive waivers extending the time for assessment to December 31, 1997 and "ABCC" was listed on the attachments as

being included in the waivers. "ABCC" and its affiliates, which included "ABCT", "ABCFMC" and "ABCEQ", having elected to be treated as a single taxpayer, were bound by the signed waiver even though the agent to whom the NOD's and the waiver were addressed was not the designated agent. Because the waiver applied to the entire unitary group, the fact that "ABCFMC" and "ABCEQ" filed separately for the years at issue does not mean that they cannot be included in "ABCC's" combined return on audit if the Department determines that they should have been included in the combined returns when "ABCC's" original returns were filed. Therefore, the Department is not barred by the statute of limitations from including "ABCFMC" and "ABCEQ" in "ABCC's" combined income tax returns as members of the affiliated group for the year ended March 31, 1991.

Whether "ABCEQ" and "ABCFMC" are Investment Companies

"ABCC" asserts that "ABCEQ" and "ABCFMC" are "investment companies". In addressing this issue, the same discussion applies to both "ABCEQ" and "ABCFMC". The Department maintains that they are "holding companies". If "ABCFMC" and "ABCEQ" are "investment companies" their business income is not taxable by Illinois.

The business income of groups of corporations, such as "ABCC" and its affiliates, that operate in numerous states and foreign countries must be divided up in some way between the taxing jurisdictions in which they conduct their business operations for it to be taxed in a constitutional manner. General Telephone Co. v. Johnson, 103 Ill.2d 363, 469 N.E.2d 1067 (1984). In Illinois there are two methods available to tax officials to determine the net income that may constitutionally be taxed by the state. Miami Corp. v. Dept. of Revenue, 212 Ill.App.3d 702, 707; 571 N.E.2d 800, 803 (1st Dist. 1991). One method is commonly known as separate accounting. *Id*. This method is employed when

the income-producing activities and sources within the State can be differentiated from the income-producing activities and sources outside of the State. [Citation omitted] *Id.* Another method of accounting is formula apportionment, which is used when the income-producing activities and sources cannot be isolated from the out-of- state activities and sources. *Id*. Formula apportionment is usually employed to allocate the net income of a unitary business. *Id*.

The IITA generally requires a unitary business group to apportion its business income using a three factor apportionment formula made up of the sales, property and payroll of the unitary group in Illinois as a percentage of the sales, property and payroll of the unitary group everywhere. IITA § 304(a). However, corporations in certain specified industries, such as some financial organizations including investment companies, are required to apportion their income using single factor formulae which differ depending on the industry.[4]

A "unitary business" has been described as "[A] group of functionally integrated corporate units which are so interrelated and interdependent that it becomes relatively impossible for one State to determine the net income generated by a particular corporation's activities within the State and therefore allocable to that State for purposes of taxation." Caterpillar Tractor Co. v. Lenckos, 84 Ill.2d 102, 116, 417 N.E.2d 1343 (1981). In relevant part, the IITA, as amended, defines the term "unitary group" as follows:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute

[4] The three-factor apportionment formula was designed to apportion the business income of manufacturing and mercantile businesses. Hellerstein, State Taxation, ¶ 9.23 (1). States have enacted special provisions for other industries for which the factor formula is deemed to be inappropriate. *Id*. The IITA requires financial organizations, among others, to use a single factor formula consisting generally of investment income and fees from sources within Illinois as a percentage of investment income and fees from all sources. IITA § 304(c).

> to each other. . . In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304 except that for tax years ending on or after December 31, 1987 this prohibition shall not apply to a unitary business group composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of Section 304, or all of which apportion business income pursuant to subsection (d) of Section 304, and a holding company of such single-factor taxpayers (see definition of "financial organization" for rule regarding holding companies of financial organizations). If a unitary business group would, but for the preceding sentence, include members that are ordinarily required to apportion business income under different subsections of Section 304, then for each subsection of Section 304 for which there are two or more members, there shall be a separate unitary business group composed of such members.
> IITA § 1501(a)(27). [Emphasis added.]

As noted previously, "ABCC" and the members of its unitary group of corporations elected under IITA § 5/502 to be treated as a single taxpayer. Accordingly, for the years at issue, they filed Illinois income tax returns on a combined basis, excluding "ABCFMC" and "ABCEQ". The income of the combined group was apportioned using the statutory three-factor formula specified in IITA § 304(a). For the year ended March 31, 1991, "ABCFMC" and "ABCEQ" filed separate Illinois returns. They did not file Illinois income tax returns on any basis for the years ended March 31, 1992 and March 31, 1993.

"ABCC" claims that "ABCFMC" and "ABCEQ" must be excluded because "ABCFMC" and "ABCEQ" are investment companies. Investment companies are included in the statutory definition of financial organizations that are required to apportion their business income using a single factor apportionment formula as specified in IITA § 304(c) rather than the three factor apportionment formula specified in IITA § 304(a) used by "ABCC's" unitary group. Thus, under "ABCC's" theory, "ABCFMC" and "ABCEQ"

cannot be included in a combined return with “ABCC” and the other members of its unitary group of companies. The result of “ABCC’s” theory is that none of the income of “ABCFMC” or “ABCEQ” would be taxed by Illinois.

The starting point for determining whether “ABCFMC” and “ABCEQ” are investment companies begins with the statutory definition of “financial organization”. For the years at issue, the statute defines the term “financial organization” as follows:

> (8) Financial organization.
>
> The term "financial organization" means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a "person" will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956.
> 35 ILCS 5/1501(a)(8)

Neither the statute nor regulations issued by the Department define the term “investment company”. However, when IITA § 1501(a)(8) was enacted, the terms used to describe certain financial organizations had commonly understood meanings derived from other statutes. When the legislature used the phrase "investment company" in section 1501(a)(8), it used the term to identify specific types of entities ordinarily allowed to use the single factor apportionment method to calculate business income. As in the case of almost all of the other types of entities enumerated in the provision, the term "investment company” identifies a particular type of financial organization that was defined in some other statute or for which specifications had been prescribed elsewhere in state or federal

statutes and regulations, or both. For example, when the legislature enacted IITA § 1501(a)(8), a "bank" had been defined and requirements for qualification provided previously in the Illinois Banking Act, Ill. Rev. Stat. ch. 16½, ¶ 102 (1969), and in various federal banking acts, e.g., the National Banking Act, 12 U.S.C. § 21 *et seq.* (1969), and the Federal Deposit Insurance Corporation Act, 12 U.S.C. § 1813 (1969). A "bank holding company" had been defined and requirements for qualification provided in the Illinois Bank Holding Company Act of 1957, Ill. Rev. Stat. ch. 16½, ¶ 72 (1969), and the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 *et seq.* (1969). A "trust company" had been defined and requirements for qualification provided in the Illinois Banking Act, Ill. Rev. Stat. ch. 16½, ¶ 101 *et seq.* (1969)). A "currency exchange" had been defined and requirements for qualification provided in the Illinois' Currency Exchange Act, Ill. Rev. Stat. ch. 16½, ¶ 31 *et seq*. (1969). And when the legislature enacted section 1501(a)(8) of the IITA, an "investment company" had already been defined and requirements for qualification provided in the Investment Company Act. 15 U.S.C. § 80a-3.

At least one state Supreme Court has acknowledged that the term "investment company" is a term of art. In Bureau of Employment Security v. Hecker & Co., the Pennsylvania Supreme Court wrote:

> [t]he term "investment company" is a term of art and refers to companies, such as mutual fund companies, whose business is to make a profit by investing in other companies. It is so defined in the Investment Company Act, [footnote omitted] in the Pennsylvania Business Corporation Law, as well as in other Pennsylvania statutes. In the absence of evidence to the contrary, we must assume that the legislature intended to use the term in this accepted business sense.
> 409 Pa. 117, 124; 185 A.2d 549, 553 (1962)

Similarly, when the Illinois general assembly used the term "investment company" in the IITA, it had recently defined the identical term in another Illinois statute. *See*, Ill. Rev. Stat. ch. 21, ¶ 64.2 ("An act to amend . . . the 'Cemetery Care Act'") (Laws 1967, p.

1189, eff. July 7, 1967) (*now codified at* 760 ILCS 100/2). In a 1967 amendment to the Cemetery Care Act, the legislature defined "investment company", in part, as a company "defined in and registered under the 'Investment Company Act of 1940' . . .."[5] While the Cemetery Care Act is obviously not *in pari materia* with the IITA, the legislature's prior definition of the same term by specific reference to the definition in the Investment Company Act is strong evidence that the legislature accepted the Investment Company Act's definition as authoritative.

Pursuant to the Investment Company Act, an "investment company" means:

> any issuer which
>
> (1) is or holds itself out as being primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
>
> (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
>
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.
>
> 15 U.S.C. § 80a-3(a).

The statutory definition, however, does not end there. Sections 80a-3(b) and (c) of the Investment Company Act specifically detail the characteristics of those organizations

[5] **The applicable amendment to the Cemetery Act's definition section provided:**

> **"Investment Company" means any issuer (a) whose securities are purchasable only with care funds or trust funds, or both; and (b) which is an open and diversified management company as defined in and registered under the "Investment Company Act of 1940"; and (c) which has entered into an agreement with the Auditor containing such provisions as the Auditor by regulation reasonable requires for the proper administration of the Act.**

Ill. Rev. Stat. ch. 21, ¶ 64.2 (1967).

which are excepted from the definition of an investment company. 15 U.S.C. §§ 80a-§§ 3(b)-(c). Although neither party addressed the statutory exceptions from the definition of an investment company, it is fundamental that related parts of a statute be read together, and not isolated or taken out of context. *See, e.g.*, Antunes v. Sookhakitch, 146 Ill. 2d 477, 588 N.E.2d 1111, 1114 (1992); Kraft v. Edgar, 138 Ill. 2d 178, 561 N.E.2d 656, 661 (1990).

Section 80a-3(b) of the Investment Company Act provides:

> (b) Notwithstanding subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:
>
> (1) Any issuer primarily engaged, directly or through a wholly owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.
>
> (2) Any issuer which the Commission, upon application by such issuer, finds and declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses. The filing of an application under this paragraph in good faith by an issuer other than a registered investment company shall exempt the applicant for a period of sixty days from all provisions of this subchapter applicable to investment companies as such. For cause shown, the Commission by order may extend such period of exemption for an additional period or periods. Whenever the Commission, upon its own motion or upon application, finds that the circumstances which gave rise to the issuance of an order granting an application under this paragraph no longer exist, the Commission shall by order revoke such order.
>
> (3) Any issuer all the outstanding securities of which (other than short term paper and director's qualifying shares) are directly or indirectly owned by a company excepted from the definition of investment company by paragraph (1) or (2) of this subsection.

15 U.S.C. § 80a-3(b)

Subsection (c) of the statutory definition provides, in part:

> (c) Notwithstanding subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:
>
> > (1) Any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. For purposes of this paragraph:
> >
> > > (A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person . . . .

15 U.S.C. § 80a-3(c)

A plain reading of these provisions establishes that "ABCFMC" and "ABCEQ" are clearly excepted from the definition of an investment company by §§ 80a-3(b)(3) and 80a-3(c)(1).

Unlike some of the other financial industries represented by the organizations enumerated in § 1501(a)(8) of the IITA, there is no Illinois counterpart to the Investment Company Act. The federal act seemingly preempted regulation of investment companies by establishing a comprehensive scheme at the federal level applicable to all investment companies. *See, e.g.*, Herpich v. Wallace, 430 F.2d 792, 814 (5th Cir. 1970) ("The technique of the Act", the Fifth Circuit Court wrote, "is to require registration with the [SEC] of all investment companies that use the mails or interstate facilities, with registration serving as the handle for the regulatory scheme."). Pursuant to § 80a-7 of the Investment Company Act, if an entity meets the definition of an investment company, it cannot conduct business in interstate commerce without first being registered with the SEC. 15 U.S.C. § 80a-7; SEC v. Fifth Avenue Coach Lines, Inc., 289 F.Supp. 3, 41

(S.D.N.Y. 1968) ("Section 7 of the Act provides in substance that no investment company, unless it is registered, shall use the means and instrumentalities of interstate commerce to buy or sell securities . . .."), *aff'd*, 435 F.2d 510, 512 (3d Cir. 1970) ("[The District Court] found Fifth to be . . . an investment company which, because it had not registered under the 1940 Act, was acting in violation of § 7(a) of the Act").

One of the means of proving that an entity is an investment company is by introducing evidence that the entity has satisfied the qualification requirements set forth in the Investment Company Act, including registration with the SEC. Not only do "ABCFMC" and "ABCEQ" fail to qualify as investment companies by statutory description, but there is no evidence in the record establishing that either "ABCFMC" or "ABCEQ" is registered with the SEC.

Given the well established meaning of the term "investment company" at the time IITA § 1501(a)(8) was enacted, the only reasonable conclusion regarding legislative intent is that to be an investment company within the meaning of IITA § 1501(a)(8), a company must be an investment company under the Investment Company Act of 1940 registered with the SEC. On this point, an Illinois Appellate Court recently addressed a situation similar to the one at issue here. Automatic Data Processing, Inc. v. Department of Revenue, 2000 WL 628727 (1st Dist. 2000).[6] The decision in that case supports the conclusion that "ABCFMC" and "ABCEQ" are not investment companies within the meaning of IITA § 1501(a)(8).

The facts in that case are similar to those involved in this case. Automatic Data Processing, Inc., ("ADP") is a Delaware corporation with headquarters in New Jersey. It

[6] Taxpayer has filed a petition with the Illinois Supreme Court for leave to appeal the appellate court decision in this case. As of the date of this writing, the Court has not acted on the petition.

created several Delaware corporations to manage the cash generated by its data processing business. ADP filed combined Illinois income tax returns for its unitary group, but it excluded the subsidiary corporations claiming they are investment companies under IITA § 1501(a)(8). The court agreed with the Department's interpretation of IITA § 1501(a)(8) that a company will not qualify as an investment company under IITA § 1501(a)(8) unless it is an investment company as defined in the Investment Company Act. "ABCC" has offered no proof that either "ABCFMC" or "ABCEQ" is an investment company qualified under the Investment Company of 1940. Therefore, neither "ABCFMC" nor "ABCEQ" is an investment company within the legislatively intended meaning of the term "investment company" in IITA § 1501(a)(8).

Whether "ABCIT" is an 80/20 corporation

After the NOD's were issued and the initial protests were filed, "ABCC" filed amended protests attaching Illinois forms IL-1120-X claiming refunds on the grounds that "ABCIT" should be excluded from the combined returns. "ABCC" asserts that "ABCIT" is an "80/20 corporation" not includible in the unitary group because 80% or more of its business activity is conducted outside of the United States. The starting point for determining whether "ABCIT" is an 80/20 corporation is the language in IITA § 1501(a)(27) that provides that:

> "The group will not include those members whose business activity outside the United States is 80% or more of any such member's total business activity; for purposes of this paragraph, . . . in the case of members ordinarily required to apportion business income by means of the 3 factor formula of property, payroll and sales specified in subsection (a) of Section 304, including the formula as weighted in subsection (h) of Section 304, such members shall not use the sales factor in the computation and the results of the property and payroll factor computations of

> subsection (a) of Section 304 shall be divided by 2 (by one if either the property or payroll factor has a denominator of zero).

ABCIT" is a member of "ABCC's" unitary group required to apportion its income using the three-factor formula of property, payroll and sales unless it can establish that 80% or more of its business activity is conducted outside the United States. Thus, as the statute provides for the 80/20-corporation test, only the payroll and property factors are used. The testimony of "John Doe", "ABCC's" senior manager of state income tax planning and compliance, and the documents of record indicate that "ABCIT" had no payroll for the years ended in 1991 and 1992. Tr. p. 36, Taxpayer Group Exs. No. 5, 6. Therefore, the only factor to be considered for the 80/20 corporation test is the property factor.

The rules for calculating the property factor are set forth in the Department's regulations at 86 Ill. Admin. Code § 100.3350. The property to be taken into account is property owned and leased by the taxpayer that is used by the taxpayer in the production of income. 86 Ill. Admin. Code § 100.3350(a). Owned property is valued at its original cost as determined for federal income tax purposes without reduction for depreciation. 86 Ill. Admin. Code § 100.3350(e). Leased property is valued at eight times the net annual rental rate.

The evidence of record relied on by "ABCC" to show that "ABCIT" qualifies as an 80/20 corporation consists of the testimony of Mr. "Doe" and Taxpayer Group Exs. No. 5 and 6.[7] Mr. "Doe" testified that, during the years at issue, "ABCIT" owned property

[7] These two exhibits are *pro-forma* U.S. Forms 1120 – U.S. Corporation Income Tax Returns for "ABCIT" for the years ended March 31, 1991 and March 31, 1992. These tax returns were not filed. They were prepared to demonstrate what tax returns would have looked like if "ABCIT" had filed its own returns.

consisting of buildings and other depreciable assets. Tr. p. 36. Referring to a document that was not offered into evidence, he testified as to the value of that property at the beginning and the end of the years at issue.

He testified that at the beginning of the year ended March 31, 1991, "ABCIT" owned property with a total value of $5.6 million of which about $5 million was located in the United States. Tr. p. 37. He testified that at the end of that year "ABCIT" owned property with a total value of $4 million of which about $3.5 million was domestic. *Id*. Mr. "Doe" testified that at the end of the following year "ABCIT" owned property with a total value of $18.8 million all of which was domestic. Tr. p. 38. He did not describe, nor was any documentary evidence offered to show, the location of either the domestic property or the property he stated was outside the United States.

Mr. "Doe" also testified that "ABCIT" rented undersea ocean cable. *Id*. He testified that "ABCIT" paid rent for undersea ocean cables of $211,103,357 for the year ended March 31, 1991, and $77,465,744 for the year ended March 31, 1992. *Id*. Taxpayer Group Exhibits No. 5, 6. However, no documentation was offered into evidence to support his testimony regarding the nature of these payments. For example, there is no evidence that the underlying documents were actually leases, giving "ABCIT" possession of the cables, rather than licensing agreements, only giving "ABCIT" the right to transmit messages across the cables. If they are licensing agreements, the licensing fees would not enter into the equation because they are not rent. On the basis of Mr. "Doe's" testimony

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"ABCIT" did not file separate returns because its parent, "ABCC", files consolidated federal income tax returns thereby negating the need for separate returns to be filed by the unitary members included in the consolidated returns. See Tr. p. 16. Mr. "Doe" testified that he did not prepare these *pro forma* tax returns but that they were prepared in the ordinary course of business and he is familiar with them. Tr. pp. 39-41.

and the information set forth on Taxpayer Group Exs. No. 5 and 6, "ABCC" calculated that well over 80% of "ABCIT's" business activity is conducted outside the United States.

The Department's *prima facie* case is established by the introduction into evidence of copies of its records under the certificate of the Director. 35 ILCS 5/914, Balla v. Dept. of Revenue, 96 Ill. App.3d 293 (1st Dist. 1981). To overcome the Department's *prima facie* case the taxpayer must present consistent and probable evidence identified with its books and records. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). A taxpayer's testimony alone will not overcome the Department's *prima facie* case. *Id*. Taxpayer's exhibits 5 and 6, the only documents in the record showing "ABCIT's" owned property and rent expense, do not substantiate Mr. "Doe's" testimony regarding the location of owned assets and the nature of the payments shown on the *pro-form*a tax returns as rent. There is insufficient evidence in the record to establish that "ABCIT" is an 80/20 corporation. Therefore, "ABCC" has failed to overcome the Department's *prima facie* case that "ABCIT" is not an 80/20 corporation.

Whether the Sales Factor was Properly Computed

"ABCC" claimed in its amended protests (Taxpayer Group Exs. No. 3, 4) that its sales factors for the three years at issue were incorrectly calculated. This issue was not raised at the evidentiary hearing and taxpayer did not address it in its post-hearing brief. There is no testimony or evidence in the record to suggest that the sales factor was incorrectly determined. Therefore, "ABCC" has failed to overcome the Department's *prima facie* case regarding the Department's determination of "ABCC's" sales factors for the years at issue.

Section 1005 Penalties

The Department assessed penalties under IITA § 1005 for late payment of tax. That section provides that the penalty is not to be assessed if the late payment is due to reasonable cause. In its protest, "ABCC" raised the issue of whether the penalty assessment was erroneously imposed because it had paid funds to the Department that was sufficient to pay the amount of tax due as shown on the IL-1120 forms as filed plus the proposed deficiencies. However, it did not present any evidence or argument regarding this issue. In the evidentiary hearing and in its brief, "ABCC" limited its argument to the issue of reasonable cause as it related to the classification of "ABCFMC" and "ABCEQ" as investment companies. "ABCC" argues that penalties should not be assessed because the late payment, if any, was due to reasonable cause.

The regulations provide that reasonable cause is to be determined on a case by case basis taking into account all pertinent facts and circumstances. 86 Admin. Code ch., I, § 700.400 at ¶ (b). The most important factor is whether the taxpayer made a good faith effort to comply with the law and if he exercised ordinary business care and prudence in doing so. *Id*. at ¶ (c)

"ABCC" argues that during the years at issue, the Department had no published regulation regarding the factors it would consider in deciding whether a company is an investment company or not. "ABCC" argues that it relied on four private letter rulings that were published prior to the years at issue in this case. In those letter rulings, the Department ruled that companies with factual situations similar to those of "ABCFMC" and "ABCEQ" were investment companies. These private letter rulings, IT 87-0179 (July 22, 1987); IT 89-0034 (February 21, 1989); IT 90-0067 (March 12, 1990); and IT-90-0218

(September 4, 1990) were revoked by the Department in August of 1993. 17 Ill. Reg. 13216 (August 6, 1993). Furthermore, private letter rulings have no value as precedents. Union Electric Co. v. Dept. of Revenue, 136 Ill.2d385, 556 N.E.2d 236 (1990), 86 Ill. Admin. Code § 1200.110. They only apply to the persons to whom they are directed. *Id*.

In addition, there was no testimony at the evidentiary hearing regarding taxpayer's reliance on these private letter rulings. The only place in the record where the taxpayer maintains that it relied on those letter rulings is in its protests. Taxpayer Group Exs. No. 1-4.

There are two reasons why the protests are not sufficient probative evidence to establish the alleged fact that whoever prepared the tax returns for the years at issue relied on them. The first reason is that the protests are hearsay evidence. Hearsay evidence has been defined as "testimony or written evidence, of a statement made out of court, such statement being offered as an assertion to show the truth of matters asserted therein, and thus resting for its value upon the credibility of the out-of-court asserter." People v. Carpenter, 28 Ill.2d 116, 121, 190 N.E.2d 738 (1963).

The protests were offered into evidence by "ABCC" and entered into the record by stipulation without objection by the Department. Hearsay evidence that is admitted without objection is to be considered and given its natural probative effect. Jackson v. Board of Review of the Dept. of Labor, 105 Ill.2d 501, 475 N.E.2d 879 (1985). In this case, there is no evidence in the record regarding who prepared the protests, and the party who signed them did not testify as to their accuracy or content. The protests merely allege that they were relied on. After they were admitted into evidence, they were not referred to again.

The second reason they are not sufficient is that they were prepared in anticipation of litigation several years after the underlying tax returns were prepared. Documents that are prepared in anticipation of litigation long after the occurrence of the events that they relate are of questionable trustworthiness and not normally admissible. See People v. Main Insurance Co., 114 Ill.App.3d 334, 448 N.E.2d 950 (1983), Tie Sys v. Telcom Midwest, 203 Ill.App.3d 142, 156 N.E.2d 1080 (1990). The protests were prepared in connection with this litigation, and they were prepared approximately several years after the tax returns were prepared. There is no testimony and the documentary evidence lacks probity as evidence that the private letter rulings were relied on at the time the tax returns for the years at issue were prepared. See Raleigh v. Illinois Department of Revenue, 179 F.3d 546, 551 (7th Cir. 1999), aff'd 530 U.S. ____, 120 S.Ct. 1951 (2000). Finally, there is no other evidence in the record demonstrating reasonable cause. Taxpayer has failed to establish reasonable cause. Therefore, the IITA § 1005 penalties are properly assessed.

For the above reasons, I recommend that the NOD dated June 18, 1996, for the years ended March 31, 1992, and March 31, 1993, identifying the taxpayer by the incorrect FEIN, be canceled. I also recommend that the other NOD dated June 18, 1996, for the taxable year ended March 31, 1991, and the NOD dated October 31, 1997, for the years ended March 31, 1992, and March 31, 1993, be made final, that the taxpayer's claims for refund be denied, and that the IITA § 1005 penalties not be abated.

ENTER: June 27, 2000

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Administrative Law Judge